

<p>CHAPTER 10: COMPLIANCE VIOLATIONS, DEFAULTS, AND WORK-OUT AGREEMENTS <i>[7 CFR 3560.453]</i></p>
--

10.1 INTRODUCTION

When routine monitoring of projects reveals noncompliance with program requirements, the Field Office must take immediate steps to notify the borrower and state of the need for timely corrective actions. To protect the security value of a property, it is in the Agency's best interest to work with the borrower to resolve any compliance violations. Resolving situations of noncompliance is the main subject of this chapter.

Loan Servicers should be firm in dealing with the borrower or the borrower's representative in matters of compliance violations. Because the management agent is not the party ultimately responsible for the loan, it is imperative that the borrower be directly apprised of and fully understands the consequences of default. Therefore, whenever any written servicing notice is sent to a management agent who is not the borrower, the borrower must also receive a copy of the notice. Loan Servicers need to employ courtesy, cooperation, and sound judgment when interacting with borrowers and management agents in any servicing situation.

A noncompliance situation is often resolved or deterred through a work-out agreement. This is a plan for resolving or deterring noncompliance that is developed and presented by a borrower to the Agency for approval. The Agency may or may not approve the proposed work-out agreement. This chapter discusses the Agency requirements for work-out agreements.

10.2 ADDRESSING COMPLIANCE VIOLATIONS AND DEFAULTS

Borrowers are in default of their loan or grant agreements whenever they are not in compliance with the terms of the loan or grant agreement. Such defaults may be of a monetary nature, such as when borrowers do not make their loan payments, or of a nonmonetary nature, such as when borrowers have not maintained projects properly. Default may be triggered by events that are beyond the borrower's control, such as changing markets that lead to prolonged vacancies. Nevertheless, being in default is a serious situation for a borrower and requires that every effort be made to resolve it.

Defaults may lead to foreclosure and loan liquidation. One significant step that can be taken toward resolving the default is for the Agency and the borrower to agree to a work-out agreement. A work-out agreement may also be used in certain cases to avert a default situation. The Agency will not pursue enforcement against a borrower in default (monetary or nonmonetary) if an approved work-out agreement is in place and on schedule. Thus, it is in the borrower's best interest to work with the Agency to resolve compliance issues through a work-out agreement.

A work-out agreement is a proposal that is submitted by the borrower to the Agency for approval of changes in project operations, for additional time to restore compliance, or for servicing actions to assist in correcting identified deficiencies. There are several servicing options available under a work-out agreement, and the borrower and Loan Servicer should consider all of them and evaluate which are the most appropriate for a specific problem project.

This chapter explains how borrowers may enter into default of their loan or grant agreement and the different types of defaults that may occur. It describes the process by which the Loan Servicer notifies the borrower of compliance violations and the options available to remedy the noncompliance. The chapter then discusses work-out agreements and includes a separate section on Special Note Rents (SNRs), which enable borrowers to reduce rents to attract tenants. By reading this chapter, the Loan Servicer will understand how to systematically work with the borrower to resolve noncompliance, when it is appropriate and feasible for a borrower to enter into a work-out agreement, what are the required terms of the agreement, and how to monitor borrower compliance with the work-out agreement.

SECTION 1: TYPES OF DEFAULTS [7 CFR 3560.452]

10.3 OVERVIEW

Borrowers in violation of the terms of the loan or grant documents for the project or applicable Federal regulations, including a work-out agreement, who fail to fully correct a deficiency by a date specified by the Agency in a written notice are in default of their loan or grant documents.

Defaults can be of a monetary or nonmonetary nature. The Agency will initiate appropriate enforcement actions against any borrower in default.

10.4 MONETARY DEFAULT

A project that is in monetary default is defined as one that is delinquent for more than 60 days. Projects with monetary violations include those for which the loans have been accelerated and of which the borrowers are in bankruptcy. A project is delinquent when a loan payment is more than 10 days past due. Project payments are due on the date specified on *Form RD 3560-52, Promissory Note*.

Monetary default may warrant the development of a work-out agreement or initiation of enforcement actions by the Agency that include termination of a management agreement, receivership, suing for performance, collection of unauthorized assistance, or denial of a rent increase.

10.5 NONMONETARY DEFAULT

Nonmonetary defaults include, but are not limited to, failing to maintain project reserves, failing to adequately maintain the physical condition of the property, failing to comply with environmental mitigation measures, occupying units with ineligible tenants without prior Agency approval, charging incorrect rents, failing to meet fair housing requirements, and failing to properly report to the Agency. A borrower will be considered in nonmonetary default if the identified deficiencies are not cured within 60 days of notification.

Attempts to resolve nonmonetary defaults should be handled whenever possible at the Field Office level with appropriate guidance and assistance from the State Office. Environmental concerns, such as failure to comply with mitigation measures, should be reviewed with the State Environmental Coordinator for further guidance. The State Director should counsel with the Office of General Counsel (OGC) for advice, if needed, in servicing those cases where nonmonetary defaults cannot be resolved at the Field Office level. These actions may include liquidation of the account, see Chapter 12.

This page intentionally left blank

SECTION 2: CONDITIONS OF CONCERN, COMPLIANCE VIOLATIONS, AND DEFAULTS

10.6 AGENCY CLASSIFICATION SYSTEM

The Agency has developed a classification system that describes the servicing status of each operational multi-family housing project. This classification system provides a picture of the status of the housing portfolio and flags those projects that need special servicing and/or monitoring. Exhibit 10-1 shows how projects are classified.

The Agency's classification system is to be used to focus servicing efforts. Projects classified as a D or a C should receive first priority when allocating resources to address portfolio concerns. Internal supervisory reviews should primarily examine how Loan Servicers are working to address projects with servicing concerns.

The classification system will be maintained on the Multi-Family Integrated System (MFIS). Servicing officials are responsible for making sure that MFIS is current and accurately reflects a project's servicing status. The supervisory visit and engagement review are key events for updating a project's servicing status. Chapter 9 of HB-2-3560 describes the Agency review process in more detail.

Exhibit 10-1

Classification System of Operational Projects

Class D includes:

- Projects in nonmonetary default having an unresolved violation for more than 60 days from the date of *Handbook Letter 301 (3560)*, *Servicing Letter #1*; and
- Projects in monetary default that are delinquent for more than 60 days

Class C includes:

- Projects with an unresolved finding or violation; and
- Projects with an unresolved violation for less than 60 days from the date of *Handbook Letter 301 (3560)*.

Class B includes:

- Projects with findings or violations with an approved work-out plan that is on schedule.

Class A includes:

- Projects with no unresolved finding or violation.

10.7 FINDINGS

A finding is determined when the Agency “finds” that a borrower is not operating in accordance with the loan or grant agreement, with Agency regulations, or with applicable local, state, or Federal laws. When the Agency discovers a deficiency in a project that requires correction but is not the equivalent of a violation or an unacceptable summary level finding during an inspection or review report, the Agency must notify the borrower of this finding. Depending on the severity of the finding, the servicing official may advise the borrower of the finding either orally, or in writing through a monitoring letter. Should the finding not be corrected after at least one written notice has been sent to the borrower with a specified date by which the finding must be corrected, the Loan Servicer must determine whether the issue should be elevated to a violation status. When the Servicing Office concludes that the finding should be viewed as a violation that could lead to a default, the Loan Servicer must begin the process of issuing the servicing letters described in Paragraph 10.10.

10.8 VIOLATIONS

A violation is a finding that the Servicing Office escalates because of its severity or because of the type of servicing effort that will be needed to obtain compliance. When the Agency designates a finding as a violation, it indicates a willingness to pursue the finding to the point of acceleration to have it corrected. Compliance violations include, but are not limited to, any unacceptable summary level finding on the physical inspection report, project management and occupancy review, or engagement review that could be updated at any time. Examples include failing to make required contributions to project reserves, failing to adequately maintain the exterior physical condition of the property under Agency standards, failing to comply with environmental mitigation measures, occupying units with ineligible tenants without prior Agency approval, charging incorrect rents, and failing to properly report to the Agency.

10.9 KEY STEPS IN ADDRESSING COMPLIANCE VIOLATIONS AND DEFAULTS

The Agency must respond quickly and systematically whenever a project is identified as being in noncompliance with program requirements. In responding to a noncompliance situation, the Loan Servicer will take some or all of the following steps and update the servicing status on MFIS:

- Notify the borrower of the violation and request corrective action;
- Meet with the borrower to discuss the problem and possible servicing actions to remedy the problem;
- Review any proposed work-out agreement developed by the borrower and suggest acceptable servicing actions if appropriate;
- Issue a problem case report; and
- Initiate enforcement actions to motivate the borrower to restore compliance.

These steps are discussed in detail in the following sections.

10.10 NOTIFICATION TO BORROWER OF SERVICING PROBLEMS

The Agency must notify the borrower using formal servicing letters that state the need for corrective action to be taken. It is not the Agency's responsibility to come up with solutions to the problems. Rather, it is the borrower who must identify what corrective actions will take place immediately or over time through a work-out agreement.

The Field Office will use a series of servicing letters to communicate with the borrower until the problem is resolved. Copies of the letters must be sent to the management agent of the property that is the subject of the letters if the owner is not the management agent. Exhibit 10-2 shows the sequencing of these servicing letters.

Handbook Letter 301 (3560) serves to trigger the start of a 60-day period for nonmonetary violations and a 45-day period for monetary violations, at the end of which the borrowers are in default of their loan agreement if the situation has not been resolved. Resolution may take the form of action proposed by the borrower and approved by the Agency, or it may take the form of enforcement actions instituted by the Agency when the borrower fails to respond or responds inadequately.

A. Preliminary Notification

When a borrower becomes delinquent on a payment, an automatically generated Delinquency Billing Statement is mailed to the borrower. The borrower will be in default if the loan payment is not made in full within 60 days of this notice. If the borrower does not submit the loan payment before the payment is 30 days past due, the borrower receives *Handbook Letter 301 (3560)*. If the borrower submits the full payment, including any applicable late fees (see Chapter 4, paragraph 4.4 on late fees) the Loan Servicer does not take any further servicing action.

During an on-site monitoring visit the monitors should meet with the borrower to review the initial results of the visit, including a discussion of compliance violations. See Chapter 9, paragraph 9.6 B of HB-2-3560 for more information about on-site monitoring visits.

Example: Borrower B's project has several crumbling steps in the stairwell. Since this represents an unacceptable condition of exterior maintenance, which is a compliance violation, the Loan Servicer notifies the borrower during the on-site visit on this violation.

Exhibit 10-2 Sequence of Servicing Letters		
Letter	Nonmonetary	Monetary
Preliminary Notification	The Loan Servicer informs the borrower of violations during a wrap-up meeting of a monitoring visit.	A Delinquency Billing Statement is automatically sent to borrower when the borrower becomes delinquent (<u>10 days</u> past due).
Letter #1	Sent upon evidence of violation and no later than <u>30 days</u> after the monitoring visit. Date of letter signifies beginning of <u>60 day</u> period to default.	Sent no later than when payment is <u>35 days</u> past due.
Letter #2	Sent sometime after <u>15 days</u> if borrower fails to respond or responds inadequately to Letter #1. Notifies borrower of date by which they will be considered delinquent if violation not corrected (60 days after date of Letter #1).	Sent after payment is <u>45 days</u> past due. Notifies borrowers of date by which they will be classified a D project (60 days after payment due date).
Letter #3	Sent at least <u>60 days</u> after date of first letter and at least <u>15 days</u> after Letter #2 notifying borrowers that they are in default and warning of enforcement action if problem is not corrected within 15 days.	Sent <u>60 days</u> after payment due date notifying borrower that the Agency will take legal action to cure the default and warning of enforcement action if payment is not made within 15 days.

B. Borrowers with Multiple Servicing Issues

If a borrower is in violation in several different areas, the *Handbook Letter 301 (3560)* should identify all the violations. If sent, *Handbook Letter 302 (3560)* would reference “ongoing compliance violations” to cover multiple servicing issues. The series of letters continues until each violation has been resolved.

A servicing letter may cite conditions of concern (see Paragraph 10.7) along with compliance violations. However, only the cited compliance violations could lead to a default status if left unresolved. If the borrower resolves all violations within 60 days, they will not default even if the conditions of concern have not been resolved.

If at any time the Agency discovers that a borrower who has received a servicing letter has another problem that warrants a servicing letter, the letter will be sent, triggering a second series of letters. These letters can run separately from and independent of the first series of letters or they may be combined at some point. However, it is important that the Loan Servicer track the separate violations cited by the date of each *Handbook Letter 301 (3560)* so that *Handbook Letter 303 (3560)* correctly identifies the violation that has resulted in the default by a certain date.

10.11 EVALUATING THE PROJECT

When the Loan Servicer has sent two servicing letters to notify a borrower of problems with a project, the Loan Servicer must evaluate the project to establish whether it is in the Agency's best interests to attempt to work with the borrower to preserve the subject project. The Loan Servicer will use the procedures outlined in Chapter 6. Such an evaluation should come before any meeting with the borrower so that the Loan Servicer is familiar with the project and its status.

10.12 MEETING WITH THE BORROWER

When the borrower proposes a work-out agreement in response to *Handbook Letter 301 (3560)*, or when *Handbook Letter 302 (3560)* must be sent, the Loan Servicer must request a meeting with the borrower. The purpose of the meeting is to identify and agree upon the servicing problem, establish the underlying causes of the problem, and begin to develop the parameters of a work-out agreement. The Loan Servicer will discuss possible Agency servicing actions.

It is the responsibility of the borrower—not the Agency—to propose and develop an acceptable work-out agreement. However, borrowers may delegate authority to their management agent to develop a work-out agreement. A borrower may do this by signing a statement in the management plan or certifying in a letter to the Agency that the management agent has the authority to act on their behalf.

Once the work-out agreement is proposed, the Loan Servicer may propose servicing actions that are appropriate and acceptable to the Agency. Section 4 of this chapter describes the special servicing actions available to Loan Servicers.

10.13 SELECTING SERVICING OPTIONS

The Agency may agree to various servicing options to resolve the compliance problems depending upon the circumstances of the noncompliance. The deciding factor will often be the quality of management.

A. Poor Management and Noncompliance with Program Requirements

Where management is poor and/or there is noncompliance with program requirements, the Agency may agree to:

- **Borrower training.** Training of resident managers may be charged as a project expense if directly related to improving project operations;
- **New management.** Hiring or changing resident managers or management agents;
- **Improving maintenance.** Change to normal, preventive, and long-term maintenance and repair programs to make the project more marketable;
- **Improving budget and record keeping, and using monthly reports.** Major expenditures should be reviewed for appropriateness; and

- **Improving outreach and marketing.** Project marketing plans, including the Affirmative Fair Housing Marketing Plan, should be reviewed and updated as appropriate.

B. Acceptable Management, but Marketability and Cash Flow Problems

Where management is acceptable, marketability and cash flow problems may be resolved through one or more of the following actions.

- Upgrading project desirability by:
 - ◇ Performing necessary and preventive maintenance;
 - ◇ Improving curb appeal at the project;
 - ◇ Improving security for tenants, such as installing deadbolts and more lighting; and
 - ◇ Improving communication between management, residents, and the community.
- Reducing expenditures by reviewing the appropriateness of operating and expense levels in relation to services rendered. It is not intended that management fees be adjusted as a condition for consideration of servicing options. Operation and expense levels may be reduced by:
 - ◇ Containing operation and maintenance costs that will not disrupt project operations;
 - ◇ Renegotiating contracts with suppliers of material and services; and
 - ◇ Temporarily deferring noncritical maintenance, provided tenant safety and project marketability are preserved.
- Temporarily reducing or deferring reserve contribution levels.
- Increasing revenues by:
 - ◇ Injecting non-project revenues;
 - ◇ Requesting rental assistance; or
 - ◇ Permitting temporary incentives to improve occupancy.
- Permitting a release of the rental assistance payments that would ordinarily go for debt service to be used for project operation and maintenance.

C. Acceptable Management, but Lack of Project Demand

Where management is acceptable, but there is a lack of project demand or a problem of obtaining and/or retaining eligible tenants, the problems may be resolved by:

- Granting occupancy waivers;
- Changing the project designation; and
- Implementing a SNR, see Section 6 of this chapter.

10.14 THE PROBLEM CASE REPORT

The Loan Servicer must develop a problem case report using *Form RD 3560-56 Report on Real Estate Problem Case* for the State Director if the Loan Servicer has sent a borrower three letters requesting corrective action to a compliance violation and the borrower has failed to provide an adequate response.

The problem case report describes the situation for the State Director and recommends enforcement action. The State Director will review the problem case report and respond to the Field Office within 30 days of receipt of the problem case report indicating the action to be taken. The State Director's response will be either:

- An agreement with the Loan Servicer's proposal for enforcement; or
- A directive for alternative servicing.

10.15 ENFORCEMENT ACTIONS

If a borrower fails to provide an acceptable work-out agreement or fails to comply with the work-out agreement, the Agency will initiate enforcement actions when liquidation is not in the Government's or the tenants' best interests. This might occur in the case of defaults that do not affect the health and safety of tenants and where the cost of liquidation is significant relative to the violation, or where the costs of liquidation and providing adequate tenant protections is high. Available enforcement actions that the Agency can take include:

- **Termination of the management agreement.** The Agency may terminate the management agreement and require the borrower to hire new management;
- **Receivership.** The Agency may appoint a third party to manage the project. When this becomes necessary, the State Director must contact OGC for assistance and provide them with alternative management agents;
- **Suing for performance under the loan document.** In such cases, the Office of General Counsel will provide assistance; and
- **Collection of unauthorized assistance.** The procedures outlined in Chapter 9 will be followed.

A. Liquidation

When it is in the Government's or the tenants' best interest to liquidate, or if enforcement actions have been unsuccessful, the Agency will initiate liquidation through either:

- Voluntary liquidation; or
- Foreclosure.

The Agency may proceed directly to liquidation if doing so will not adversely affect tenants. Normally this is reserved for cases where the borrower has abandoned the project or a partnership has been dissolved, leaving no legal entity in place to oversee the property. Properties where serious health and safety concerns exist are the most likely to go straight to enforcement or liquidation. Chapter 12 provides details on liquidation.

B. Debt Settlement

If the property is worth less than the outstanding Agency debt, it may be in the government's best interest to settle the debt using its debt settlement procedures. Compromise offers to settle outstanding debts may be part of a work-out agreement accompanying a transfer. Chapter 12 provides further details on debt settlement.

SECTION 3: DEVELOPING A WORK-OUT AGREEMENT

[7 CFR 3560.453]

10.16 OVERVIEW OF WORK-OUT AGREEMENTS

A work-out agreement is a proposal submitted by a borrower to the Agency for approval of changes in project operations, additional time to restore compliance, or other special servicing actions to assist in correcting identified deficiencies. A borrower may submit a work-out agreement at any time in response to Agency notification of compliance problems or prior to that if the borrower feels that noncompliance is imminent.

The work-out agreement may be a very simple one page plan for resolving a single problem, or it may be a more complex document of several pages that describes several plans of action to resolve a more complicated problem. If a borrower does not develop a work-out plan, the Loan Servicer must develop a problem case report, in accordance with Paragraph 10.14.

Acceptable and successful work-out agreements depend upon some flexibility on the part of the Loan Servicer and the borrower, thoughtful and project-specific servicing, and thorough and consistent monitoring that serves to track the progress of the agreement.

10.17 CONDITIONS WARRANTING A WORK-OUT AGREEMENT

Serious compliance deficiencies that cannot be resolved promptly may warrant the development of a work-out agreement. Such conditions may reflect a financial, physical, fair housing, or occupancy deficiency.

A. Financial Deficiencies

Financial deficiencies that may require a work-out agreement include:

- Inadequate cash flow to meet project needs. Cash flow should be adequate to pay Agency debt, meet reserve requirements, pay taxes, pay insurance, pay other project expenses, and pay any authorized return on owner investment when earned;
- Projects that are 60 days past due;
- Seriously underfunded reserve accounts that cannot be brought up to required levels within a normal budget cycle or where unauthorized withdrawals have been made; and
- Borrowers who have not adhered to program requirements such as paying taxes, maintaining insurance, or submitting required financial information.

B. Physical Deficiencies

Physical deficiencies that may require a work-out agreement include failure to maintain decent, safe, and sanitary housing opportunities for residents and maintenance that has been deferred for so long that it has become a financial burden to the project.

C. Fair Housing Deficiencies

Fair housing or Section 504 violations and problems with tenant certification and project occupancy requirements may warrant the development of a work-out agreement.

D. Occupancy Deficiencies

Serious vacancies that threaten property viability where management can furnish evidence that they have made efforts to increase occupancy may warrant a work-out agreement.

10.18 ELIGIBILITY FOR WORK-OUT AGREEMENTS

The Agency will consider work-out agreements only for properties:

- That are deemed to be program property; or
- Whose owners demonstrate a commitment to correcting property deficiencies.

A. Program Property

The Loan Servicer must establish whether the project is suitable for the program using the guidance provided in Chapter 6. If the project is deemed to be non-program property, a work-out agreement must not be considered.

B. Owner Evaluation

An owner who has not maintained compliance with prior work-out agreements and has historically ignored Agency requests for corrective actions must not be considered eligible for a work-out agreement.

10.19 CONTENT OF A WORK-OUT AGREEMENT

All work-out agreements must be in writing and executed by the borrower, or the borrower's designated representative, the management agent who manages the project (if different from the borrower), and the Agency before they take effect. The work-out agreement must correct all deficiencies that have been identified in a project.

Exhibit 10-3 lists the information that must be included in a work-out agreement.

10.20 CONDITIONS PLACED ON THE BORROWER

Borrowers must forgo and cannot recoup the annual return to owner for the budget year in which a work-out agreement is in effect.

Exhibit 10-3

Recommended Format for Servicing Work-out Plan (SWP)

Background information. Provide history and describe past goals and accomplishments.

Description of the problem(s) to be solved. Identify project weaknesses and needs making sure to cover:

- Compliance deficiencies (e.g., delinquent amounts, underfunded reserves, nonpayment of taxes, deferred maintenance, unacceptable tenant file records, noncompliance with accessibility and fair housing issues, etc.); and
- Serious financial concerns (e.g., high vacancies, inadequate cash flow, high Operations & Maintenance (O&M) expenses.).

Underlying causes of problem. Attempt to identify the cause of the problem. Attempt to recognize when problems identified are symptoms or the results of the same underlying causes.

Overview of plan to correct problem. Provide a summary of the plan and identification of key assumptions used in projections.

How the plan will work. Provide details on how the plan will work with attached supporting documentation (i.e., budget), when appropriate. A timetable for completing the work-out plan and key components of the plan (i.e., plan calling for capital improvements should identify the improvement proposed, cost with supporting estimates, source of funds, and completion dates).

Anticipated results. Clearly identify the goals to be reached. Have periodic, measurable interim goals to determine that full implementation is on track.

Written work-out plans. All work-out plans must be in writing and must be executed by the borrower or the borrower's designated representative, and Rural Development. A copy of the executed work-out plan will be placed in the case file; copies will be given to the borrower, management agent, and the State Director.

Time frames for implementing and completing the plan. Prior to approval, all plans must be evaluated on whether the plan realistically achieves the objectives of the loan. All plans must be reevaluated at the end of the two-year period. If the plan includes a time frame for completion of more than two years, the plan must be revised and reexecuted at the end of each year to determine if satisfactory progress has been made.

Monitoring working plans. The following statements must be a part of the plan immediately above the signatory line:

“The management agent is responsible for making quarterly progress reports with regard to plan compliance to Rural Development and the borrower. The first report will be due no later than 100 days from the date of Rural Development approval and every 100 days thereafter.”

Check appropriate box:

- ☐ Initial SWP
- ☐ Renewal of SWP
- ☐ Renegotiated SWP. There have been _____ previous SWPs on this account.

10.21 PRIORITIES IN MEETING EXPENDITURES

In developing work-out budgets for projects experiencing cash-flow difficulties, the following priorities will be used:

- First priority is to meet obligations to the prior lienholder, if any;
- Second priority is for critical project operating and maintenance expenses, including taxes and insurance;
- Third priority is for Agency debt payments;

- Fourth priority is for reserves; and
- Fifth priority is for other project needs.

10.22 LENGTH OF TERM AND AUTHORITIES

A. Term of Work-Out Agreement

The maximum term of a work-out agreement is two years. All agreements must be reevaluated annually as well as at the end of the two-year period. The evaluation is based on whether the plan realistically achieves financial viability and otherwise meets the objectives for which the loan was made. If an approved work-out agreement calls for actions that extend beyond a two-year period, borrowers must submit an updated and if necessary, revised work-out agreement to the Agency for approval. The updated work-out agreement must be submitted to the Agency 30 days prior to the expiration of the work-out agreement in effect. The Agency may reexecute the agreement if satisfactory progress has been made.

Reserve Account Deficiencies

When seriously underfunded reserve levels are involved in an extended work-out time period, the Loan Servicer should reassess the reserve level for the project and establish a new reserve level, if appropriate. A capital needs assessment can be useful to make this determination. If re-funding the reserve to its new level will require more than two years, the borrower and Loan Servicer may want to consider additional work-out terms so that the project is not in continual need of requiring a work-out agreement.

Normally, work-out agreements should not exceed two years, especially if a plan calls for less than full payment on an Agency loan, or less than full contribution to the reserve account. Plans not meeting these criteria are normally not considered as viable and feasible.

B. Authority to Approve Work-Out Agreements

1. Field Offices

Delegated Field Office staff can approve work-out agreements that correct deficiencies within 12 months, except when the agreement includes a special servicing action per Section 4.

2. State Offices

Delegated State Office Staff approves any work-out agreements that:

- Are for longer than 12 months;
- Require reduced or zero loan payments;
- Require contributions to reserves of less than that which is required plus 10 percent of the delinquent amount; or
- Include loan adjustments or writedowns.

10.23 AGENCY REVIEW AND APPROVAL [7 CFR 3560.453(b)]

Work-out agreements are a tool that the Agency can use to work with the borrower to effectively resolve defaults if the borrower is acting in good faith to actively propose realistic corrective actions. Approval of a work-out agreement is not guaranteed to a borrower. Failure to approve a work-out agreement is not an adverse action by the Agency because the Agency is not required to grant approval of modifications to the terms of the loan for borrowers in default; thus, the Agency is not taking away any borrower rights by not approving the work-out agreement. Therefore, failure to approve a work-out agreement is not appealable by a borrower, although the Agency's decision may be reviewed.

A. Evaluation of Work-Out Agreement

The Agency is under no obligation to offer or agree to any special servicing actions contained within a proposed work-out agreement. In evaluating the borrower's proposal, the Agency will accept work-out agreements that meet the following criteria:

- The proposed actions effectively correct the deficiency;
- The proposed time frame for correction is reasonable and realistic for correcting the deficiency;
- There is evidence of adequate borrower commitment of resources, considering the cause of the problem, (e.g., a lesser commitment may be appropriate if the problem was caused by circumstances beyond the borrower's control);
- The proposed special servicing actions for the Agency (e.g., reamortization, writedown) is in the interest of the Government and the tenants, and the costs of

- continuation are not more than the costs of liquidation and providing tenant protection; and
- The proposed actions are consistent with the borrower's management plan. If the proposed actions are not consistent, the management plan must be updated.

B. Procedures Following Approval of Agreement

The approved work-out agreement will be signed and dated by the Approval Official, the borrower, and the management agent, if different from the borrower, and will be attached as an addendum to the management plan for the project.

10.24 CANCELING A WORK-OUT AGREEMENT

A work-out agreement may be canceled by whoever approved it 10 days after discovering a borrower's noncompliance with its terms. If the official who originally approved the work-out agreement is not available, then the official who has assumed that individual's responsibilities will be responsible for canceling the agreement and notifying the borrower.

SECTION 4: SPECIAL SERVICING ACTIONS

10.25 SPECIAL SERVICING ACTIONS THAT MAY BE A PART OF A WORK-OUT AGREEMENT

A number of special servicing actions may be proposed and approved as part of a work-out agreement. As shown in Exhibit 10-4, these servicing actions may be divided into two broad categories: changes in project operations and changes to the loan account. This section describes other servicing actions, most of which are less extreme.

A. Servicing Actions to Change Project Operations

The borrower may propose one or more servicing actions that will produce a change in project operations. Some of these actions are discussed in detail in other sections.

Exhibit 10-4 Special Servicing Actions That May Be Part of an Approved Work-out Agreement	
<u>Changes in Project Operations</u>	<u>Changes to the Loan Account</u>
<ul style="list-style-type: none"> • Rent changes and/or preparation of a new budget • Occupancy waivers • Temporary incentives to improve occupancy • Special note rents (SNRs) • Changing management agent or management plan • Changing project designation • Transfer of ownership • Substitution of partners 	<ul style="list-style-type: none"> • Loan reamortizations • Loan adjustments (writedowns) • Loan consolidation • Deferral of payments • Prepayment/compromise offer • Providing rental assistance (if available) • Recasting the entire loan (i.e., “starting fresh”)

1. Rent Changes or Preparation of a New Budget

To achieve financial stability, the borrower may propose a new budget that shows a change in rents or operation costs. In evaluating the request, it may be appropriate for the Agency to analyze the current market in which the project is located to see whether the project rents compare favorably with rents for similar properties in the market. Rent incentives will be allowed as described in paragraph 10.25 A.3 of this section, but the change and accompanying budget will be conditionally approved by the Agency subject to meeting the requirements in Agency regulations, see Chapter 7 of HB-2-3560. If the

Agency receives comments from tenants that warrant a different decision from the one made when the work-out agreement was conditionally approved, the Agency must inform the borrower of these discoveries and make any needed adjustments to the conditionally approved budget.

In reviewing these changes, the Loan Servicer must evaluate both short- and long-term budget projections so as to establish whether the project is likely to achieve its financial goals during the work-out period, and whether the project is likely to achieve and maintain financial viability in the long term. The Loan Servicer must evaluate whether projections show repayment ability after the work-out agreement objectives are met based on realistic vacancy, rent rate, and/or reamortization assumption.

Any projected capital improvements shown in the budget must be accompanied by statements that describe the work to be done, the estimated costs with supporting material, the projected time frame for completing the work, and the source of funds to be used for the improvements.

2. Occupancy Waivers

When a project is experiencing high vacancies and eligible tenants are not available, the borrower may request to temporarily solve the problem by renting to ineligible tenants. Ineligible tenants might be individuals whose incomes or family sizes are above the maximum limits or who do not meet an occupancy requirement, such as an age limit.

A request to rent to ineligible tenants may be approved by the Loan Servicer based on the following determinations:

- There are no eligible persons on the waiting list;
- The borrower has made a diligent but unsuccessful effort to rent any vacant units to an eligible tenant; and
- The borrower will continue to seek eligible tenants and will submit the following to the Field Office;
 - ◊ *Form RD 3560-29; and*
 - ◊ A report of efforts made to locate eligible tenants.

The borrower must agree to the following conditions:

- The units may be rented to ineligible tenants for no more than one year, following which the lease must convert to a monthly lease. A statement to this effect must be included in the lease;
- Tenants who are ineligible because their household income exceeds the maximum for the project will be charged the Agency-approved SNR, if applicable; and

- Without Agency approval, management may assign a larger or smaller unit than the household needs if the household is otherwise eligible. Tenants must agree to transfer to a correctly sized unit when one becomes available and must pay all costs associated with moving. A statement to this effect must be included in the lease.

3. Temporary Incentives to Improve Occupancy

The borrower may request temporary incentives to improve project occupancy. These incentives may not exceed the life of the work-out agreement. The Agency may grant such incentives when project management has been acceptable and under the following conditions:

- The project is encountering unacceptable vacancy levels.
- The incentives are short-term, modest, and consistent with program objectives.
- Recipients are given a clear understanding of the extents and limits of the incentives.
- The use of incentives is fully accounted for on project budgets and annual reports.
- Occupancy incentives will be paid from the following sources:

Temporary Incentives to Improve Occupancy

1. Security deposit reductions or waivers and extended security deposit payment period.
2. Reduced rents in the form of rebates, coupons, or a temporary agreement.
3. Free rent.
4. Reduced or free utilities.
5. Referral fee payments.
6. Rent-up gift to tenant, such as a savings bond or gift certificate.

- ◇ Non-project sources;
- ◇ Forgone return to owner; and
- ◇ Project funds when it can be shown to be cost-effective, which means that the revenues derived will outweigh the costs of providing the incentives.

4. Special Note Rents

The borrower may request a SNR to reduce the note rate rent to attract tenants who can afford to pay more than 30 percent of their incomes in rent and utilities but who will not pay the existing note rate rent. This servicing action is discussed in detail in Section 6 of this chapter.

5. Changing the Management Agent or Management Plan

Where poor management is evidenced by a record of failing to comply with Agency requirements, the borrower may elect to change management. Where the Agency has notified the borrower of the need to change management, financial incentives under work-out agreement provisions may not be approved until the borrower changes

management, or agrees to change management within a reasonable time frame.

6. Changing the Project Designation

When a market has changed such that the type of tenant who would qualify for the project is no longer available and vacancies are resulting, the borrower may request a change in project designation. The State Director will consider such a change when the following information has been provided:

- The complete borrower case files will be submitted together with the Loan Servicer's specific recommendations and analysis of the present and long-term situation;
- Market feasibility documentation, which may include inquiry lists from the project or waiting lists at other nearby and similar properties, which shows that other tenants are available to occupy the project. Market feasibility documentation must also clearly indicate that the present long-term marketability of the project is significantly changed from the original market, and must include the appropriate demographic information that reflects the population trends in the area. The market feasibility documentation must also show if the demand is for the bedroom-sized units in the project or if different sized units would be more desirable;
- A summary of all servicing actions taken by the Agency to aid the borrower in maintaining the present designation;
- A summary of all actions taken by the borrower to effectively market the units to potential eligible tenants;
- A summary of the impact the change will have on any existing tenants, rent subsidy needs, and the community as a whole; and
- A summary of any needed or required physical modifications and analysis of cost feasibility to complete the modifications, including modification to unit sizes in terms of number of bedrooms.

7. Transfer of Ownership

In some cases, the only means of addressing project concerns is through replacement of the borrower. Some reasons that may require a transfer of ownership include:

- Illness or death of a borrower;
- Financial difficulties that cause a borrower to terminate his or her business operation; and
- Fraudulent activity, as determined by the Office of the Inspector General (OIG).

Where work-out agreements call for a change in the borrower, the Agency may temporarily approve financial concessions contingent upon the borrower agreeing to seek a transfer of ownership. The borrower must agree to provide evidence that ownership

replacement is being actively pursued. Should ownership replacement not be achieved within an agreed-upon time frame, liquidation of the account may be appropriate.

When a transfer occurs as a result of noncompliance, the transferee (new borrower) must provide a plan for bringing the project into compliance as part of the application package. For example, the loan payments and reserve account may be behind schedule. The transferee provides a plan that identifies the source of funds to meet these conditions.

Chapter 7 provides the details on approving and processing transfers of ownership.

8. Substitution of Partners

The borrower may request a substitution of general partners as a way to inject new resources into the borrower entity. Chapter 5 provides the details on approving and processing substitution of partners.

B. Changes to the Loan Account

Proposed servicing actions may require changes to the loan account such as those that are described in Chapter 11.

1. Deferral of Payments

Deferring any debt payment to the Agency is an extreme measure that should be used as a last resort. Deferring a portion of the Agency debt and using this deferred amount to build up reserve funds may only be approved when the funds are being used to pay identified critical project needs. For example, when a roof must be replaced within the next two years, the work-out agreement may call for deferring payments in an amount equal to the cost of replacing the roof and this amount will be deposited into the reserve account. The critical need must be identified and closely monitored to ensure compliance.

Deferral of payment by the Agency should usually be accompanied by a borrower contribution of financial resources to the project.

Deferring debt payments should not exceed two years. National Office approval must be obtained when longer periods of time are justified.

2. Change of Payments

Scheduling loan payment in accordance with the borrower's repayment ability. The provisions must be documented. The issuance of *Form RD 3560-29A, Multiple Family Housing Statement of Payment Due*, will normally be suppressed during the period in which a work-out agreement calling for less than the normal full scheduled installment is effective. To suppress issuance of *Form RD 3560-29A*, process by using the appropriate screen on the Automated Multi-Family Housing Accounting System (AMAS); see the AMAS manual for specific instructions on how this is done. Upon expiration of the work-out agreement, a review will be conducted to determine any further servicing actions that may be appropriate (e.g., reamortizing, rescheduling, executing a new

servicing plan and/or supplementary payment agreement that may call for higher than normal payments, preparing a problem case report, etc.). As long as a borrower is meeting the provisions of an approved work-out agreement calling for less than full installments, late fees will be waived.

3. Prepayment

A borrower may offer to pay their loan in full, ahead of the scheduled loan repayment date and exit the program. In such an event, the project will no longer be a part of the Multi-Family Housing program, will no longer be subsidized by the Agency, and will no longer be subject to Agency regulations and procedures. Chapter 15 provides the details on approving and processing prepayment requests.

4. Voluntary Conveyance

Voluntary conveyance is a method of liquidation by which title to security is transferred to the Federal Government. The State Director is authorized to approve voluntary conveyance of property if the total indebtedness, including prior and junior liens, does not exceed their approval authority. Chapter 12 provides the details on approving and processing an offer of voluntary conveyance.

5. Provision of Rental Assistance

Where there is servicing rental assistance available, the State Director may agree to provide rental assistance to a project as part of a work-out agreement in order to enable tenants who could otherwise not afford the rents to move into a project and improve vacancy.

SECTION 5: MONITORING THE WORK-OUT AGREEMENT AND SUBSEQUENT SERVICING

10.26 MONITORING WORK-OUT AGREEMENTS

Once a work-out agreement has been developed and approved, the Loan Servicer must monitor the borrower's progress and provide guidance as needed. This is an important and necessary component of ensuring the success of the work-out agreement. The monitoring serves to make sure not only that the terms of the agreement are being upheld, but that they are having the desired effect of moving the project back into compliance. If not, the Loan Servicer must work with the borrower to amend the agreement to incorporate servicing techniques that will achieve the desired goals or cancel the work-out agreement and move to implement enforcement measures.

The Loan Servicer will conduct the monitoring in the following ways:

- Reviewing the financial reports submitted by the borrower. These include *Form RD 3560-7*, which must be submitted on a quarterly basis and bank statements, if appropriate;
- Holding quarterly meetings at the project site with the borrower to track the progress of the work-out agreement; and
- Conducting supervisory visits to monitor progress with an agreement. Such visits are mandatory to determine if the work is being done when the work-out agreement includes correcting deferred maintenance or when reserve funds are being used for repairs. These supervisory visits should be held in conjunction with the quarterly meetings with the borrower.

10.27 SUBSEQUENT SERVICING AND IMPACT ON FUTURE LOANS

Any member of a borrower entity with a controlling interest in a property in which there are serious noncompliance issues and no work-out agreement is in place, or where the entity is in noncompliance with its work-out agreement, will not be eligible for further Agency loans. In a case such as this, the borrowers must make arrangements to restore compliance with Agency requirements and restore their financial viability.

In cases where the borrower and the Agency work together to make an acceptable work-out agreement, the borrower may be eligible to receive additional assistance after they have been in compliance with the work-out agreement for six consecutive months. In cases where work-out arrangements cannot be made, the primary basis for denying such assistance would be based on the borrowers' inability to meet eligibility requirements, shown by their track record of failing to meet existing requirements and responsibilities for other projects.

This page intentionally left blank

SECTION 6: SPECIAL NOTE RENTS (SNR)

10.28 OVERVIEW OF SPECIAL NOTE RENTS [7 CFR 3560.210]

When a project is experiencing severe vacancies due to market conditions, the State Director may allow a borrower to charge a SNR rent to attract and keep tenants who have the financial ability to pay more than basic rent but who will not pay the current note rate rent. An SNR addresses the situation where some existing and prospective tenants are not willing to pay 30 percent of adjusted income or note rate rent because the rental rates would exceed those of other rental properties in the community. This action may only be taken after supervisory efforts by the Agency and management efforts by the borrower have not produced an acceptable level of occupancy.

10.29 SNR ELIGIBILITY REQUIREMENTS

A. Required Project Conditions

The borrower must document that the following conditions exist in the project for the Loan Servicer to consider allowing an SNR to be implemented:

- The project has been operational for at least 24 months (the borrower may request a waiver to this provision);
- No more than 10 percent of budgeted expenses are reflected as unrestricted cash on hand, and reserve account balances do not exceed the required accumulation-to-date minus authorized withdrawals;
- Over the most recent six-month period vacancy rates have averaged at least 15 percent or the project shows revenue losses of at least 15 percent;
- The loss of rents available is not a result of management's failure to effectively market the units; and
- Comparable rents in the area are lower than the previously approved note rate rents.

B. Borrower Requirements

To be eligible for the SNR, the borrower must:

- Be in compliance with Agency regulations and encourage occupancy through good maintenance and positive relations with tenants;
- Sign a statement agreeing to forgo return to owner for the duration of the SNR;
- Submit a budget with only the minimal sufficient operation and maintenance expenses;

- Have engaged in aggressive marketing efforts, including:
 - ◊ Significant outreach efforts in the community, including, but not limited to, contacts listed in the AFHMP; or
 - ◊ Obtaining approval from the Agency for a servicing work-out plan, exclusive of SNR features, at least three months earlier.

10.30 SUBMITTING AND PROCESSING SNR REQUESTS

In making the request for an SNR, the borrower submits the same information as they would when requesting a rent change. See Chapter 7 of HB-2-3560 and 7 *CFR 3560.203*.

The Loan Servicer reviews the documentation from the borrower and forwards the information with a recommendation to the State Director, who makes the final decision. If the decision is to approve the SNR, the following steps will be taken:

- Adjust the note rate column in the proposed changes to rent section of *Form RD 3560-7* to reflect rents needed for payment to the Agency amortized at an interest rate that is less than the full note rate on the borrower's *Form RD 3560-52*. The interest rate chosen may never be less than two percent.
- Set the interest rate of the SNR budget at a level that will make project SNR rates comparable with community rental rates.
- When an SNR is implemented in a Plan II Section 8/515 project, use lines 23 through 29 of *Form RD 3560-29* to report any additional payments to the reserve account required when HUD contract rents exceed SNR rates.

When the Approval Official determines a request for an SNR is not justified on the basis of the information submitted, the Approval Official will notify the borrower in writing of the reason(s) why the SNR is not approved. The borrowers will be advised of their appeal rights in accordance with 7 *CFR* Part 11.

10.31 CHANGES TO AND TERMINATION OF SNRS

Borrowers must request changes to SNRs at the time of budget review. If the local market conditions have not changed since the SNR was implemented, then no change is made to the SNR. If the conditions have changed, then the SNR is changed accordingly.

The borrower must notify tenants of the project in which the SNR is proposed to be changed just as would be done for tenants where a regular rent change request is made.

An increase in an SNR will be handled in accordance with regular program requirements for a rent change. See Chapter 7 of HB-2-3560.

An SNR is terminated when the note rate rent is regained.

10.32 RESTRICTION ON NEW UNITS

While an SNR is pending or in effect, the Field Office must not review or approve any other projects—of any type—in the same market area. State Directors may seek National Office approval for a waiver from this provision when an SNR has been in effect for 24 months.

This page intentionally left blank

SECTION 7: ENFORCEMENT

10.33 MULTI-FAMILY HOUSING ENFORCEMENT TEAM

The Agency has established a Multi-Family Housing Enforcement Team to improve the Agency's efforts to detect and eradicate fraud, waste, and abuse in the Multi-Family Housing program. The mission of the Enforcement Team is to protect the interests of residents; ensure quality housing; restore public trust in Government investments; and eliminate program fraud, waste, and abuse. Within the scope of its mission, the Enforcement Team provides the following services:

- Performs problem property reviews including data reviews, site visits, interviews, reports on findings, recommendations for remedial actions, and follow-up actions to ensure problem resolution;
- Coordinates multi-state reviews of problem borrowers and management agents;
- Recommends enforcement actions to ensure borrower/agent compliance with regulatory and statutory program requirements;
- Analyzes problem property data collected by Field Office Staff and provides feedback concerning administrative actions for Field Office Staff to pursue in relation to problem properties;
- Coordinates enforcement efforts with the OIG, OGC, Department of Justice, Department of Housing and Urban Development, Federal Bureau of Investigation, and the Internal Revenue Service, as appropriate;
- Provides technical assistance and advice to Field Office Staff;
- Develops training materials and conduct training related to problem property analysis and enforcement techniques;
- Develops a standardized process to deal with problem properties and ensure comparable actions are applied in similar cases; and
- Guides field staff with appropriate actions to ensure resolutions of recommendations from OIG audits.

10.34 REQUESTING ENFORCEMENT TEAM SERVICES

Activities of the Enforcement Team may be initiated by the Deputy Administrator for Multi-Family Housing or by a request from a State Office.